No. 11823

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

LEO M. HARVEY and LENA P. HARVEY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONERS.

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TABLE OF AUTHORITIES CITED

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The argument of the Respondent in his opening brief presents the following *hiatus* which he has failed to explain.

As was set forth in Petitioner's original brief, the sale to Gerrard occurred on March 21, 1938, at which time Petitioner received $25,000 in cash and ten negotiable promissory notes, each in amount and having a fair market value of $40,000, maturing serially commencing April 2, 1939, through April 2, 1948. The Petitioners regularly reported income on the accrual basis and under proper accounting practice and the provisions of Sections 41 and 42 of the Internal Revenue Code, all of the gain from the sale *accrued* in the year of the sale, 1938, unless the transaction qualified as an installment sale under Section 44 of the Internal Revenue Code. From the facts

in the case, it is clear that the sale did not qualify as an installment sale under Section 44(a), but in preparing their returns for 1938 and subsequent years, Petitioner took the position that the transaction constituted a *casual* sale of personal property and could be reported by installments under Section 44(b). If the Court should determine that the sale of patents to Gerrard was not a *casual sale,* all income from the sale would have been realized by the Petitioner in 1938, and could be taxed only in the year realized. *Burnet v. Sanford & Brooks Co.,* 282 U. S. 359, 75 L. Ed. 383; *Georgia School-Book Depository, Inc.,* 1 T. C. 463; *Acme Coal Co. v. United States,* 70 Ct. Cls. 696, 44 F. 2d 95.

The Respondent contends, at pages 13 and 14 of his brief, that the sale of patents to Gerrard was a sale of property held by Petitioner primarily for sale to customers in the ordinary course of taxpayer's trade or business. The Commissioner, in a published ruling, has held that such a sale is not a *casual* sale under a section of the revenue law comparable to 44(b) of the Internal Revenue Code. G. C. M. 1162 VI-1, C. B. 22. Consequently, if the Commissioner should establish that the sale of patents was a sale of property held primarily for sale to customers in the ordinary course of taxpayer's trade or business, he would at the same time establish that the sale was not a *casual* sale for which income may be deferred on the installment basis under Section 44(b). Consequently, all of the income which was realized in 1938 could only be taxable to the Petitioner in the year 1938, a year not before the Court.

The Motion for Judgment on the pleadings filed in the Tax Court and the subsequent amendment to the Petition before the Tax Court advised the Respondent of the above

hiatus in his position prior to the trial in the Tax Court. Even assuming, as Respondent suggests, that the *hiatus* should not have been resolved on the pleading, nevertheless it would appear that this Court must resolve the *hiatus* in reaching a decision.

Respondent, in its brief, also takes the position that the sale of patents by Petitioner was a sale of property used in Petitioner's trade or business as an inventor. This, of course, presumes that Petitioner was in the trade or business of inventing, and that such patents were used in such trade or business. Both presumptions appear to be unsupported by the facts. From the Record, it appears that during the period from 1913 until 1938, Petitioner patented not more than four or five inventions, and the ones in question are the only ones he ever sold. It does not appear that he devoted a great deal of time to such inventions. If the activity of the Petitioner in making one sale of an invention during the period of his life, is a *casual* sale under Section 44(b), how can the Respondent contend that Petitioner engages in sufficient inventive activities to be engaged in that trade or business? Casual sales are not sufficient to constitute carrying on a trade or business. *Greenwood,* 34 B. T. A. 1209; *M. E. Trapp v. United States,* (D. Ct. W. D. Okla.) 485 C. C. H. 9371.

Nor is the fact that Petitioner sold a patent created by his own personal services sufficient to make the sales price ordinary income rather than capital gain. It is established that an inventor may realize capital gain from the sale of his own invention. *Carl G. Dreymann,* 11 T. C. No. 23, (August 9, 1948); and see Bureau Acquiescence, 1946—1 C. B. 3 in the case of *Edward C. Meyers,* 6 T. C. 258; also, as pointed out by the Supreme Court in *Eugene Higgins v. Commissioner,* 312 U. S. 212, 85 L. Ed. 783,

the mere fact that activity is engaged in for a profit does not mean that such activity constitutes the carrying on of a trade or business. The possibility of profit is the customary motive which prompts people to maintain, conserve and sell property.

It would appear that the recent decisions of the Tax Court in *Carl G. Dreymann,* 11 T. C. No. 23 (August 9, 1948), is most persuasive in determining the issue herein presented. In that case, Petitioner was a chemist and consulting engineer who earned his living by chemical and engineering research. Mr. Dreymann, while in the business of manufacturing certain products out of fish oil, invented a process for substituting fish oil in the manufacture of steel. This patent, he sold to United States Steel Corporation. During the period from 1931 to 1942, apparently Mr. Dreymann devoted almost his entire time to the development of a process for moisture-proofing paper and paper board. He obtained certain patents on such processes. The record in the *Dreymann* case is replete with evidence of his continuous activity over many years regarding this invention. The Tax Court found that in 1935 Petitioner sold this patent after devoting approximately four years to research and development. The Tax Court determined that the income received by Dreymann for the sale of the patents for moisture-proof paper was capital gain and not ordinary income because Dreymann was not in the trade or business of being an inventor. It would appear that the personal service activities of Mr. Dreymann in creating the patent which

was sold, were much more extensive than any activities of this Petitioner.

It is also important to note that in the *Dreymann* case, the Court found that his 19-year-old daughter, a high school graduate, had an undivided one-half equitable interest in the patent because of services which she rendered in assisting Mr. Dreymann in creating the patent. All patents were in the name of Dreymann and the daughter did not have any legal interest in the patents. It would appear that the Tax Court should have held that Herbert Harvey had an equitable interest in Petitioner's patents. The evidence amply supports such a finding.

Respondent has contended that the burden was on Petitioner to establish that the 20% compensation to Lawrence Harvey for services rendered was reasonable. Such a position is hardly consistent with the position which Respondent's attorneys took at the Tax Court hearing wherein he objected on the ground of immateriality to a question asked Petitioner relating to the extent and nature of services rendered by Lawrence [R. 74]:

> "We have no question here as to the reasonableness of any compensation paid to Lawrence Harvey."

It is respectfully submitted that Petitioner receive the relief as prayed for in Petitioner's opening brief.

Respectfully submitted,

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